

No. 10933

IN THE

United States Circuit Court of Appeals
FOR THE NINTH CIRCUIT

ETHEL STRICKLAND ROGAN, as Executrix of the Last
Will and Testament of Nat Rogan, Deceased,

Appellant,

vs.

FERNAND MERTENS, also known as Fernand Gravet, and
VICTORINE CATHERINE RENOURD MERTENS,

Appellees.

APPELLEES' REPLY BRIEF.

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APPELLEES' REPLY BRIEF.

Questions Presented.

Were the amounts advanced to appellee Fernand Mertens by his employer subsequent to the closing of appellees' taxable year includable in their income for the period prior to such closing?

Were the amounts so advanced to appellee Mertens by his employer so that he would have funds to pay a demand of the Collector of Internal Revenue which the employer considered unlawful a loan to the appellee?

Statement of Facts.

The pertinent facts are adequately and accurately set forth in appellant's brief. We believe it would serve no useful purpose to repeat them here.

ARGUMENT.

I.

The Action of the Collector of Internal Revenue in Demanding That Appellee Mertens Pay, as a Condition of Being Granted Permission to Leave the Country, a Tax Based Upon Amounts Which the Collector Thought Might Be Payable to Appellee at Some Time in the Future Was Arbitrary and Capricious.

When Mrs. Mertens applied to the Collector of Internal Revenue in June of 1938 for a certificate of compliance with the internal revenue laws, which she had to obtain in order to leave the country, she was required to pay a tax in the amount of \$3,245.92. In view of subsequent developments, it is significant to note that in computing this amount, the Collector considered only income already received. He made no effort to estimate or determine what her income might be for the remainder of the year and did not require the payment of tax on any such future income.

When, however, Mr. Mertens applied for a certificate of compliance in the latter part of August, 1938, the Collector not only demanded the payment of taxes on the income of Mertens and his wife which had already been received, but in addition demanded the payment of a much larger tax arrived at by including in the appellees' income the sum of \$40,017.41 which he thought might become payable to Mertens by his employer in the future. Apparently, the reason for the Collector thinking that certain additional sums might be payable was due to the fact that under a contract of employment between Mertens and Loew's Incorporated, Loew's agreed to pay Mertens a certain sum and, in addition, to pay "all taxes which may

lawfully be assessed" thereon. The amount of \$40,017.41 was apparently arrived at by a complicated mathematical formula, which has the following effect: First, the tax is computed upon the income actually received; the tax so computed is then added to the income and a new tax computation made; since the second computation obviously results in a larger tax than the first, the difference is then added to income and a third computation made; this process is repeated over and over until the additional amounts to be added become insignificant.

Apparently, the Collector in including in income, upon which his tax computations were based, amounts which he thought might become payable in the future did so on the grounds that such amounts were "constructively" received. This position is so specious as scarcely to warrant serious consideration. We appreciate fully that in many instances funds may be so available to a taxpayer or so subject to his control as to permit the conclusion that they constitute income in advance of their actual receipt. A common example is where interest is credited to a taxpayer's bank account. The interest is quite properly considered income to the taxpayer because it is available to him even though not actually withdrawn from the account. Again, where interest coupons mature, the taxpayer cannot avoid including the interest in income by the simple expedient of failing to detach the coupons and surrendering them for payment. Similarly, where compensation is clearly due and owing to an employee and the employer is both willing and able to pay, the compensation may be considered income even though the employee fails to take the necessary steps to obtain payment until a later date. In other words, where the situation is such that amounts owing to a taxpayer may be obtained simply

for the asking, they may be considered for tax purposes as though actually received.

We are not confronted with any such situation here. The obligation of Loew's Incorporated to pay appellee's taxes was limited to taxes "which may lawfully be assessed." [R. 25; Finding of Fact No. 11.] In other words, the employment agreement definitely contemplated that there should be a determination of appellee's taxes and a lawful assessment of the amount thereof as a condition of any liability on the part of Loew's to pay. The only thing in the nature of an assessment involved herein is the demand itself. Prior to such demand, appellees were in the same position as any other taxpayer reporting on the calendar year basis for the year 1938. Although one might make a tentative computation of their tax liability based on the assumption that the income already received would represent the total net income for the entire year and although one might conjecture or guess as to future income and losses and thereby arrive at an estimate of what the total liability might be, there was no certainty as to whether there would be a liability or the amount thereof. Thus, immediately prior to the demand, one of the essential elements of "constructive" receipt, *i. e.*, the existence of an obligation to pay, was totally lacking.

Appellant implies (App. Br. pp. 15 and 16) that the demand itself constituted an assessment which gave rise to the obligation on the part of Loew's to pay which, in turn, caused the amount of such obligation to be "constructively" received by appellees. This implication is suggestive of the old adage about lifting oneself by one's boot straps. Clearly, the demand *followed* rather than preceded the determination of appellees' income. Accordingly, for the demand to be lawful, the income upon which

based must have been realized actually or "constructively" *prior* to the time the demand was made. If such income was not realized prior to the demand, and we think we have clearly shown that it was not, then the demand was excessive and unlawful. The fact that appellees may have subsequently thereto received or "constructively" received income cannot cure it.

If there are any degrees of error, the action of the Collector was particularly erroneous in pyramiding taxes upon taxes. If the Collector had been content to demand a tax computed upon the income already realized, it might be reasonable to assume that in the normal course of events, Loew's would have recognized an obligation to pay the amount thereof and would have paid such amount. The tax as so computed would have amounted to \$23,734.80. [R. 25; Finding of Fact No. 12.] There is, however, absolutely no basis whatsoever for assuming that Loew's would have recognized an additional obligation to pay any taxes which appellees might have been required to pay on such amounts (*i. e.*, the taxes on \$23,734.80). Whether or not an obligation on the part of an employer to pay an employee's taxes on his compensation carries with it an obligation also to pay any taxes employee may be required to pay on the amounts previously paid as taxes is an open question on which much may be said on both sides. We do not believe it necessary here to enter into a prolonged discussion of the pros and cons of this question. We think it is apparent that the Collector acted arbitrarily and capriciously in blithely assuming that the obligation to pay taxes on taxes so clearly existed as to warrant the conclusion that the amount thereof could be considered as already realized by appellees prior to the making of his demand.

Any possible lingering doubts as to whether the amounts in question were "constructively" received by appellees prior to the demand should be swept away when it is remembered that prior to the demand, the attorney for Loew's, Mr. Leon Levi, had several conferences with the Collector concerning the amount of appellee's liability. At at least one of such conferences, Mr. Levi informed the Collector in no uncertain terms that Loew's would not recognize an obligation to pay any such amount contemplated by the Collector and subsequently demanded by him. [R. 197.] Thus, the Collector, at the time of his demand, had knowledge that the liability on the part of Loew's would be disputed. In view of this, we think it is ridiculous and absurd to contend that the amount of the alleged obligation of Loew's was as good as received, *i. e.*, "constructively" received by appellees at the time of the demand.

Although appellant has not as yet done so, appellant may possibly attempt to justify the action of the Collector on the grounds that where an alien is about to depart from the country, the Collector is not limited to demanding payment of a tax computed on income already realized, but may include in his computations income which he estimates may be realized during the remainder of the calendar year. Before discussing this matter, we wish to make it clear that the question is not whether the Collector's estimate in the instant case was a reasonable one. With respect to that question, we might say, in passing, that we think it was reasonable to have anticipated that appellees would receive some additional income from Loew's Incorporated. On the other hand, we think it was unreasonable to assume that they would receive the full amount which the Collector included. The question with which we are here concerned, however, is not whether

the estimate was reasonable, but whether the Collector was entitled to include estimated income in his computations or whether he was limited to income actually or "constructively" received at the time of making his demand.

Section 146 of the Internal Revenue Code, under which the Collector purportedly acted in the instant case, provides that where a taxpayer is about to depart from the United States, the "Commissioner shall declare the taxable period for such taxpayer *immediately* terminated and shall cause notice of such finding and declaration to be given the taxpayer together with a demand for immediate payment of the tax for the taxable period so declared terminated." (Emphasis added.) There is some uncertainty as to the exact effect of the action of the Commissioner in terminating a taxpayer's year pursuant to this section. One possibility is that the section means what it literally says and that when the year is terminated, it is terminated for all purposes, with the consequence that the calendar year which would otherwise be the taxable year is divided into two taxable periods—one covering the period from January 1 to the date of termination and the other from the date of termination to December 31.

There is some uncertainty in the instant case as to the exact date on which appellees' taxable year was terminated. Presumably, it was September 1, the date specified in the returns which the Collector prepared for the appellees and caused them to sign. [R. 152: Ex. 8, p. 88a.] However, the exact date is immaterial as obviously it must have preceded the demand and also preceded the advance or loan of funds from Loew's to the appellees. Since the income of one taxable period may not be included in another taxable period, it follows, of course, that if the taxable year terminated by the Collector was a separate

and distinct taxable period, he should have included therein, in computing the taxes therefor, only the income attributable to such period. Since, as shown above, the amounts which he estimated would subsequently be received by the appellees, were not received or "constructively" received prior to the close of the taxable year which was terminated by the Collector, it follows, of course, that such amounts should not have been included in computing the taxes due for such period.

Another possible construction of Section 146 is that, notwithstanding the literal provisions of the section, the action of the Collector in closing the taxable year only operates to close it tentatively and that the year still remains open so that the final tax liability therefor will be determinated at the end of the year based upon the entire income and deductions therefor including the income and deductions after it was tentatively closed as well as the income and deductions prior to the tentative closing. This construction is suggested by the General Counsel for the Treasury Department in *General Counsel Memorandum 17195 (Government Bulletin XV-44-8368, November 2, 1936)*. See also *Ludwig Littauer & Co., Inc., v. Commissioner*, 37 B. T. A. 840.

But even if the action of the Collector does not actually close the taxable year but only closes it tentatively, we fail to see how this construction of this section authorizes or justifies the Collector in including for the period from the beginning of the year to the date of the tentative closing, income not attributable to that period, but which, if realized at all, is attributable to the remaining portion

of the year. To hold otherwise would result in giving absolutely no effect whatsoever to the provisions respecting the closing of the year. In effect, the section would be construed as if it provided that the Collector could, where a taxpayer is about to depart from the country, estimate the income for the entire taxable year and compute and demand the payment of a tax on such estimated amount.

We suggest that even under the tentative closing construction, the section should be construed as an authorization and direction to the Collector to proceed as *if the taxable year were closed*. In other words, even though the year is still open, for the purposes of finally computing the tax liability for the year, where a taxpayer is about to leave the country, the Collector may proceed at that time as if the year were closed and compute and demand the payment of a tax on the income already received up to that date. He is not, however, authorized to estimate, conjecture, or guess as to what the taxpayer's income might be for the remainder of the year and is not entitled to demand the payment of taxes on such estimated income. Thus, in the case of a taxpayer leaving in January, the Collector would not be justified in demanding the payment of a tax on income which he thinks the taxpayer might receive during the remaining eleven months of the year. Similarly, in the instant case, where the taxpayer gave notice of intention in August that he was about to depart from the country, the Collector was not authorized to demand the payment of taxes on income which might be received subsequently.

II.

**There Is Ample Evidence to Support the Findings
of the Trial Court That the Amounts Advanced
by Appellee's Employer Constituted a Loan.**

If the appellees' taxable year was actually closed for all purposes on September 1 or thereabouts, then, of course, it is immaterial whether the amount subsequently advanced by Loew's to provide appellees with funds to pay the amounts demanded by the Collector constituted a loan or constituted income to appellees. Even if such payment resulted in the receipt of income by appellees, the income was realized in a subsequent taxable period which is not involved in this proceeding. If, however, the closing on or about September 1 was only a tentative closing for the purpose of computing a tax on income previously realized with the consequence that the tax liability for the calendar year 1938 must be computed upon the entire income for the entire year, then it becomes necessary to consider whether the amount advanced to appellees in September constituted a loan or was income to them.

As pointed out above, the amount which the Collector demanded from appellees was arbitrary and excessive. In normal instances where taxpayers are faced with such a demand, they may protest the demand, request a conference and, if necessary, eventually file a petition with the Tax Court. Appellee Mertens, however, had no such alternative. He either had to post a bond to secure the payment of the excessive demand or obtain funds with which to pay it. If he had posted a bond and then at the close of the year 1938 filed returns reporting his actual income, there is no question that the liability for the year would have been only \$23,734.80 or less rather than \$40,017.41, which was demanded by the Collector. Simi-

larly, if the appellee had borrowed the necessary funds from a bank or from some other lending agency and had paid the Collector's demand and then subsequently instituted suit for refund, there is likewise no question that the correct liability would have been held to be \$23,734.80 or less. Under these circumstances, we see no reason why a different conclusion should be reached because Loew's happened to lend him the money with which to pay the demand.

Under the tentative closing theory, the demand itself was not an assessment. The actual assessment was not made until some months later. [R. 27; Finding of Fact No. 15.] Since the obligation of Loew's to pay Mertens' taxes was limited to taxes lawfully assessed, there was, accordingly, no obligation to pay Mertens any additional amount at the time of the advance and, consequently, such payment cannot be considered as discharging any obligation of Loew's to Mertens. But even if the demand is regarded as an assessment, it was plainly not a lawful assessment and, hence, it would still follow that there was no liability to pay Mertens any additional amounts at the time of the advance.

The court below found that the parties in treating the advance as a loan acted in good faith. [R. 28; Finding of Fact No. 16.] See also the lower court's Order for Judgment [R. 21] where the court states that "to treat such a loan as income would require us to disregard unchallenged facts and acts, the good faith of which has not been impugned by the government, and to substitute therefor highly speculative considerations." There is nothing whatsoever in the record to suggest that the idea of treating the advances as a loan was decided upon for the purpose of avoiding taxes. On the contrary, the record quite plainly suggests that the parties were forced

to this arrangement because of the arbitrary and unlawful action of the Collector in demanding payment of taxes upon income not yet realized and which might not be realized. To hold that, under these circumstances, the advance was not a loan but was income would, in effect, be to allow the government to profit by its own mistakes. We do not believe that such a result should be countenanced.

Conclusion.

The conclusions of law and judgment of the District Court are correct and fully supported by the facts. Accordingly, the judgment should be sustained.

Respectfully submitted,

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